

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

Date:

Employer Identification Number:

Key District:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

According to your Form 1023 Application and related correspondence, you were formed on [REDACTED] as a [REDACTED] nonprofit corporation. Your main activity will be to provide services to publicly or charitably-funded economic and community development loan funds, in order to help develop an active secondary market for economic development loans. One of the main problems of economically-distressed areas is lack of capital. Governments have traditionally responded to the problem by funding local, nontraditional lending organizations known as revolving loan funds (RLFs). With cuts in government funding, RLFs are looking to private capital for additional funding. Securitizing loan portfolios has been identified by many government agencies and RLF managers as one of the primary options to accomplish the task.

However, there are several impediments to securitizing these loans that have frustrated the development of a meaningful secondary market. One is that RLFs are unwilling to accept a steep discount on the sale of their loans in a conventional manner. Another is that most RLFs have found the costs of securitization of their individual portfolios (given their small size) to outweigh benefits. Investment bankers have not pursued securitization of such loans because they see other activities as more lucrative, because efforts to assemble loan pools from the decentralized RLF universe are more labor-intensive, (due partly to the small size of RLF portfolios and the lack of information on them), because RLF administrators have less experience with such transactions, and because of the risky nature of such loans.

[REDACTED]

You plan to help RLFs profitably securitize their loans by pooling various RLF loans to achieve the size and composition necessary for cost-effective transactions. You will identify investors and determine their specifications, and match them with appropriate RLF portfolios. This activity will occupy 90% of your time, and will be self-supported through fees (1% of nominal value of loans securitized), assessments, and other related revenues. Services will be provided only to RLFs that are 501(c)(3) organizations or government-funded.

Grants permitting, you will devote the remaining 10% of your time to related educational activities, including participating in conferences and seminars; helping RLF's evaluate the benefits and costs of securitization and other recapitalization activities; engaging in related research endeavors; and providing technical assistance to RLFs in their business practices.

You have no members and a board of three directors who elect themselves. You plan to expand the board after exemption is recognized. Projected annual compensation levels of your president and vice president are in excess of [REDACTED] each. You will attempt to conduct a survey to verify the propriety of your projected compensation prior to hiring the officers.

You request advance 509(a)(2) status. You anticipate receiving fees from 15-21 RLFs in your second year of operations, and 20-28 RLFs in your third year. You are applying for grants from private foundations.

Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax organizations organized and operated exclusively for charitable or certain other purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the Income Tax Regulations states that the words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization "operates exclusively" for 501(c)(3) purposes only if it engages primarily in activities that accomplish such purposes. It does not operate exclusively for 501(c)(3) purposes if more than an insubstantial part of its activities does not further such purposes.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes under Section 501(c)(3) of the Code unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled by such private interests.

Rev. Rul. 69-528, 1969-2 C.B. 127, held not exempt under section 501(a) of the Code an organization formed to provide investment services for a fee exclusively to 501(c)(3) organizations. The organization was free from the control of the participants and had absolute and uncontrolled discretion in investing decisions, distributions of income or principal. The Service reasoned that providing investment services on a regular basis for a fee is a business ordinarily carried on for profit and would constitute unrelated business if conducted by one tax-exempt organization for other tax-exempt organizations (citing section 502).

Rev. Rul. 71-529, 1971-2 C.B. 234, held exempt under section 501(c)(3) of the Code an organization that provided assistance in the management of investment funds of member 501(c)(3) universities for a charge substantially below cost. The organization received capital from the participating exempt organizations and placed it in common funds in the custody of various banks. These common funds were controlled and managed by the organization. The funds were invested upon the advice of independent investment counsel retained by the organization. Its board of directors was composed of representatives of the member organizations. Each member had the right to an accounting of its pro rata share of the investment funds and could withdraw from participation upon thirty days notice. The organization did not make its services available to anyone other than the exempt organizations controlling it. Most of the operating expenses of the organization, including the costs of the services of the investment counselors and the custodian banks, were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee (less than 15% of the total costs of operation) for the services performed. The Service reasoned that the organization's investment activity was an essential function of the exempt universities, and that the organization performed its activity in a charitable manner by charging its charitable members a fee substantially below cost. The Service distinguished the organization from the one described in Rev. Rul. 69-528 in that the latter organization was primarily engaged in carrying on an investment management business for

charitable organizations on a fee basis free from control of the participants.

Rev. Rul. 72-369, 1972-2 C.B. 245, held not exempt under section 501(c)(3) of the Code an organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations. The Service reasoned that providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit, and providing such services at cost solely to exempt organizations is not sufficient to characterize the activity as charitable.

In Better Business Bureau v. United States, 316 U.S. 279 (1945), the Supreme Court considered the meaning of "exclusively" in the 501(c)(3) predecessor provision. The Court held that the existence of a single non-exempt purpose, if substantial in nature, will destroy the exemption.

In American Institute for Economic Research v. United States, 157 Ct.Cl. 548, 555, 302 F.2d 934, 937-38 (1962), cert. denied, 372 U.S. 976 (1963), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization was founded by an individual who was director, cotrustee, and life member, and who received a salary. The organization's stated purposes were to conduct scientific research in economics and disseminate the results to educate the public in economics. The organization published two periodicals which contained brief analyses of industries and individual securities. Subscribers were entitled to a quarterly list of securities recommended by the organization. The organization provided various investment advisory services for a fee. The organization also trained students in economics, but this activity was relatively small in scale with intermittent interruptions. The court reasoned that the organization's exempt purposes were incidental to its primary purpose to conduct business. The court noted that even though the organization's activities may have been educational, the organization had profits, the organization's services were commonly associated with commercial enterprises, and the organization received no bona fide charitable contributions, which indicated a substantial nonexempt purpose.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The court considered such factors as the particular manner in which the organization's activities were conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits as relevant

[REDACTED]

evidence of the organization's predominant purpose to conduct a business. The organization's sole planned activity was to offer consulting services for a fee to nonprofit organizations having limited resources (some of which were exempt organizations) and engaged in various rural-related activities. The organization's goals were to help its clients deal with problems they face regarding the external environments within which they operate, change their priorities, implement realistic internal planning and management policies, and improve their understanding of governmental policy processes and methods for becoming more effective in their work through public and private funding. The organization obtained appropriate individuals to perform research projects for the clients. The organization did not advertise its services. The organization's officers planned for the first few years to serve without compensation. The fees charged by the organization were set at or close to cost and were to some extent based on the client's ability to pay, but as a whole were intended to cover its costs. The organization projected a net profit in its first year of operation. The organization failed to show that it was not in competition with commercial enterprises, which the court considered strong evidence of the predominance of a nonexempt commercial purpose. The court contrasted the case to one where an organization, concededly conducting substantial educational, scientific, or charitable activities, also conducts a trade or business related to its exempt functions. The organization's activity of linking researchers with client organizations was not inherently charitable, and the organization failed to show that such research would further exclusively exempt purposes. The organization's sole source of support was fees for services. The organization's clientele was not limited to section 501(c)(3) organizations.

In Senior Citizens Stores, Inc. v. United States, 602 F.2d 711 (5th Cir. 1979), the court upheld the Commissioner's determination that the organization's retail sales operation was an end in itself rather than merely a means of accomplishing a charitable goal, and therefore the organization was not devoted exclusively to charitable purposes. The organization's stated purpose was to provide training, jobs, places of recreation, and living accommodations, and to improve the physical and mental conditions of aged or senior citizens. The organization engaged in the business of selling used clothing, furniture, and household appliances which were donated to the organization by the general public. Its affairs were run by a board of three directors, two of whom were father and son. The organization reported net income. Although half of the organization's 13 employees were over 55, their training was restricted to the

needs of plaintiff's business, and the organization conducted no training program beyond the training of employees for its own shops. The organization did not provide any housing facilities or health care. 10% or less of the donated items were distributed directly to needy senior citizens, although no complete records were kept of such distributions and the organization apparently conducted no advertising to let senior citizens know of the availability of such items. There was no evidence that senior citizens received a discount on purchases from the stores. The organization maintained a recreation hall above one of its three stores. The only evidence of business proceeds devoted to the recreation hall was a \$160 monthly salary paid to its part-time director. The court concluded that the business was not distinguishable from that of many typical family-operated businesses in which the excess of income over expenses is paid to various family members as rents or salaries.

In Christian Manner International, Inc. v. Commissioner, 71 T.C. 661 (1979), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code where the organization's primary activity was the publication and sale of books written by its founder which were religiously inspired and oriented but were sold commercially at a profit, its other planned religious activities were not specifically planned out and were not yet put into effect, and its publication and sale activities competed with other businesses which marketed religious literature. The organization's sources of support were book sales and contributions, but many of the "contributions" were made in exchange for a book for a minimum contribution exceeding the list price of the book.

In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization was organized to operate a pharmacy to sell drugs at discount prices to elderly and handicapped persons. It had no commitment to use excess receipts to provide drugs for free or below cost to the elderly or handicapped. The organization served elderly and handicapped people almost exclusively, and did not sell toiletry articles, magazines, cards, or other items normally sold for profit by pharmacies. The organization's board consisted of community leaders, none of whom obtained any personal financial benefit from participation. The organization used the services of volunteers (for mailing prescriptions, completing patient profiles, maintenance, etc.) instead of paid employees. All gifts were used for the benefit of financially distressed senior citizens who, because of a catastrophic illness or accident, incurred large prescription drug bills. The court reasoned that

[REDACTED]

the organization operated its business primarily for commercial purposes, in competition with profitmaking drug stores. The mere fact that products sold by the organization were helpful to health did not necessarily entitle it to exemption under section 501(c)(3).

In Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code to an organization formed primarily to operate vegetarian health food restaurants and stores on the ground that the organization had a substantial commercial purpose. The court considered the particular manner in which an organization's activities were conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits as relevant evidence in determining whether the organization had a substantial nonexempt purpose. The organization at issue competed with other restaurants, set its hours and prices competitively with area businesses using pricing formulas common in the retail food business, spent substantial sums in advertising which was commercial in style, was unable to show any donations of food to the poor, and had substantial gross profits (although no net profits) during the years at issue (its first two years).

You plan to help RLFs obtain more capital with which to make economic development loans, by helping them sell their loans receivable. However, your proposed operations also look like those of a financial or consulting services business for profit. You would not be described in section 501(c)(3) of the Code unless the beneficiaries controlled you and your services were provided substantially below cost, under the reasoning of Rev. Ruls. 69-528, 71-529, and 72-369. However, you are not controlled by exempt organizations, and your services will not be provided substantially below cost. Your executive officers will be highly paid, and there is no indication that you will receive substantial assistance from volunteers. It also appears that your proposed educational activities will serve partly to advertise your portfolio securitization services. Your proposed activities appear to be directly competitive with for-profit businesses and do not appear to differ in any significant respect other than your focus on RLFs, and you have not provided evidence in support of your assertions to the contrary. Under the circumstances, we find that you are operated primarily for the purpose of conducting a business, and that the charitable aspects of this business are incidental. Thus, you are not operated exclusively for exempt purposes, but also for a substantial non-exempt purpose to conduct business for its own sake. In this

[REDACTED]

respect, you are similar to the organizations denied exemption in Revenue Rulings 69-528, 71-529, and 72-369, and the cases American Institute for Economic Research, B.S.W. Group, Inc., Senior Citizens Stores, Inc., Christian Manner International, Inc., Federation Pharmacy Services, Inc., and Living Faith, Inc..


Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

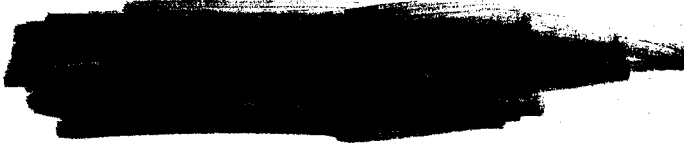
You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key district office. Thereafter, any questions about your federal income tax status should be addressed to that office. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).



When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:



If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

